June 20, 1988

[ADDRESSEE]

Dear

The [Issuer] has requested the staff of the Commodity Futures Trading Commission ("Commission") to inform [the Issuer] whether the staff would recommend that the Commission take action against [the Issuer's] proposed issuance of notes designated as . . . ("Notes"). That request was made at a meeting with Commission staff on January 14, 1988. Based upon the characteristics of the Notes, which resemble yen-denominated debt instruments, and the other matters discussed below, the staff has determined that it will not recommend to the Commission any enforcement action based upon the issuance of the proposed Notes.

[The Issuer], the proposed issuer, is a stockholder-owned corporation chartered by an Act of the Congress . . .

All securities issued by [the Issuer], which carry "AAA" investment grade ratings from various rating agencies, are deemed to be exempt securities under the laws administered by the Securities and Exchange Commission (SEC), to the same extent as obligations of the United States.

From discussions with [the Issuer] and the materials included in the January 19, 1988 Memorandum, in particular the Offering Circular, the staff understands the proposed offering to be as follows. [The Issuer] will issue unsecured, non-callable, registered notes having a five-year maturity period. The Notes,] will bear issued in minimum denominations of U.S. \$[interest at a specified rate of return payable in U.S. dollars,] face value of the semiannually. At maturity, each \$[principal amount of the Note will be payable in an amount equal] minus the U.S. dollar equivalent to the formula of U.S. \$[] Japanese yen, or other rate reflective of market conditions at the time of issuance. The appropriate exchange rate at the maturity of the Notes will be determined by an average dealer price quotation. The Notes will be issued

pursuant to an Offering Circular which is consistent with disclosure requirements of the SEC applicable to registered issuers. The Notes will be marketed to the public as debt security instruments and not as having the "beneficial characteristics of commodity options or futures contracts." (January 19 Memorandum at 14). [The Issuer] further represents that it fully hedges its foreign currency risk in the forward market simultaneously with its issuance of debt that carries such a risk.

The proposed Notes may be characterized as "hybrid instruments," in that they combine certain elements of traditional commodity interests with those of debt instruments. The combination of commodity interests with instruments which traditionally have been viewed as debt-like creates certain risks which, in futures, options on futures, and options on certain physical transactions, are addressed by futures exchange or Commission rules.

Although [the Issuer] contends that the Notes are not "classic" futures contracts (January 19 Memorandum at 4), neither are they "classic" debt instruments. The Notes have two distinct components. First, they contain a traditional debt component which provides for the semiannual payment of interest. example, similar Notes issued by [the Issuer] in . . . paid interest to the holder at a rate of . . . per annum in return for use of the loan capital extended for the term thereof, in that case . . . years. The coupon yield on this component of the transaction was higher than the market rate for a comparable pure debt instrument issued or offered by [the Issuer] or a comparable The currency-indexed component of the Notes enables the Note purchaser to participate in the change in the value of the yen versus the dollar calculated as an adjustment to the principal amount of the Note when due, in effect either reducing or increasing the payment at maturity.

On December 11, 1987, the Commission issued an advance notice of proposed rulemaking which requested comment from the public on, among other matters, the commodity-related risks associated with hybrid instruments in contemplation of developing a regulatory framework for the treatment of such instruments. 52 F.R. 47022. ("Advance Notice"). The comment period, which was extended, ended on April 11, 1988. 53 F.R. 2510 (January 28, 1988). In view of the fact that the Advance Notice remains pending and that the Commission has not reached a final determination with respect to the proposals set forth therein, the staff believes that it is appropriate, in limited circumstances such as this, to address certain instruments on a case-by-case basis.

Although the Notes are not specifically encompassed by the Advance Notice, the staff believes that the no-action position set forth herein is not inconsistent with the basic framework of analysis contained in the Advance Notice as outlined below. Under the Advance Notice proposal certain otherwise regulated hybrid instruments with "incidental" commodity option components would be subject to exemption from the Commission's rules subject to specified conditions. Although the risk/return characteristics of the Notes, despite their "capping" feature, cannot be characterized readily as those of options, it is nevertheless instructive to review the conditions for exemption set forth in the Advance Notice.

The Advance Notice proposed several tests to establish whether the commodity option component of a hybrid option instrument is merely incidental to the overall nature of the instrument, including: (1) the term to maturity of the instrument, (2) the commodity-based return vis-a-vis the return of the entire instrument, and (3) the relation of the instrument to its offeror's line of business. In any event, hybrid instruments would not be eligible for exemption where the "predominant purpose [of the transaction is] the conveyance of an interest in an option on a commodity or the functional equivalent of such a commodity interest." 52 F.R. 47025. In the Advance Notice, the Commission also sought comment on further specific requirements for affording an exemption from full regulation by These included requirements that the offeror of the Commission. a hybrid instrument have a net worth of at least \$100 million; that it maintain cover for or reserves of the commodity; and that the instrument be otherwise regulated by another federal authority.

Based upon the representations of [the Issuer], the offering documents, and the staff's review, it appears that the commodity interest component of the Note proposed to be offered by [the Issuer] distributes returns between the lender and the borrower based upon the direction and magnitude of the price change in the Japanese yen relative to the U.S. dollar. 1/ The Note can be viewed as a coupon-bearing instrument where repayment of

^{1/} For example, if at maturity the value of the yen is equal to the benchmark value of yen per dollar, there is no gain or loss for the holder of the yen-indexed feature of the Note, and the bond principal of \$ is paid at maturity. If the yen weakens significantly against the dollar, for example to yen per dollar, then the (Footnote Continued)

the principal has been indexed to the yen on a one-to-one basis. The traditional coupon component of the Notes provides an interest payment denominated in dollars and the principal is repaid based on yen value, such that the Notes provide a fixed interest payment together with a principal return resembling, in many respects, a yen-denominated bond which, when converted into dollars, reflects the prevailing exchange rate. As a result of this indexation feature, the maximum gain or loss on the , an amount equivalent to the bond commodity component is \$ principal amount. Consequently, the commodity-related component of the transaction, which results in a one-to-one increase or reduction in payable principal in accordance with the yen exchange rate, is reflective of a foreign currency-denominated debt interest. In addition, although the Notes contain certain incidental futures-type elements affecting the distribution of risk, their other characteristics preclude ready characterization of the Notes as futures equivalents.

(Footnote Continued)

yen-indexed component of the Note will yield \$ (\$ maximum gain from the yen depreciation minus the remaining \$ value of the yen) in addition to the \$ principal repayment. The Note holder's position would achieve its maximum profit of \$ in addition to the \$ principal repayment if the yen became worthless against the U.S. dollar. Thus, in the case of a depreciation of the yen, the total payment at maturity of the Note would be equal to the principal repayment of \$ plus the gain on the yen-indexed component of the hybrid instrument, such as the \$ or \$ in the above examples.

In contrast, the holder of the Note loses if the yen strengthens relative to the dollar. However, these losses are capped so as to equal, at most, the \$ principal payment. If the yen strengthened against the dollar from yen per dollar to, for the initial contract value of yen per dollar, then the amount of principal example, payable at maturity is \$ minus the dollar value of yen per dollar) for yen divided by ven or \$ (i.e., , with the \$ principal repayment decreased a loss of \$ by that amount. Expressed differently, the formula for the payment at maturity of the Note is \$ minus the \$ value for a total of \$

Due to the various characteristics of the Notes, the staff will not recommend to the Commission any enforcement action under Section 4(a) of the Commodity Exchange Act based upon the issuance of the proposed Notes. The staff position also is based upon the representations of the issuer, including those relating to the marketing and disclosure that will accompany the proposed offering, the particular terms and conditions of the proposed Notes, and upon agreement by [the Issuer] to submit to special calls for information with respect to the Notes and the matters addressed herein.

This position does not excuse [the Issuer] from complying with any otherwise applicable provisions of the Commodity Exchange Act, nor does it address any other offering or proposed offering by [the Issuer]. This position is based upon the facts and representations contained in [the Issuer's] letter and conversations with the staff. Any different, omitted or changed facts or conditions might require a different conclusion. Moreover, it should be noted that this position is that of the staff and is not binding upon the Commission and that any subsequent determination by the Commission with regard to the outstanding Advance Notice may require a reconsideration of this position for subsequent offerings.

Sincerely,

Marshall E. Hanbury
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Commodity Futures
Trading Commission
Off-Exchange Task Force

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